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SUBJECT: FRANCHISING IN MEXICO PART I: AN OVERVIEW

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This is the first in a series of two cables reviewing the franchise sector in Mexico.

¶1. (SBU) Summary. Buoyed by increased purchasing power, a commercial real estate boom, and greater investor confidence, franchises are transforming the retail sector in Mexico. The franchise industry is an increasingly important component of the Mexican economy, creating thousands of new jobs and providing new opportunities for domestic and foreign investors. Hampered in the past by a lack of small business credit, new private and public sector initiatives may enable Mexican entrepreneurs greater access to capital, spurring economic growth and development. End Summary.

FRANCHISE SECTOR GROWTH

¶2. (SBU) According to data provided by the Mexican Franchise Association (MFA) and the National Institute of Statistics (INEGI), the franchise sector now accounts for over 5 percent of GDP, with more than 500,000 direct hire employees. In 2005, it grew by 17 percent, generating over 8 billion dollars in sales and producing 80,000 new jobs. Franchising has also expanded geographically; while in the past most franchises were in Mexico City, today they are found in every region. Approximately 68 percent of franchises are Mexican and 27 percent are from the U.S. - although chains from other nations, including Argentina, Brazil, and China, are planning large-scale investment in Mexico. Most analysts predict that the growth rate will remain above 15 percent in 2006, with no sign of slowing.

¶3. (SBU) Foreign franchising in Mexico has had several growth stages, beginning with the introduction of the first McDonalds franchise in Mexico City in 1985, followed by KFC, Arby's, Subway, and others. However, many of these companies were negatively affected by consumer unfamiliarity, over reliance upon U.S.-produced supplies (resulting in higher costs and uncompetitive prices), and the peso devaluation of 1994-1995. A key for the recovery of the sector was the passing of Article 142 of the Industrial Property Law, which codified legal protections for both the franchisor and the franchisee. Although some franchises that closed in 1994-1995 have yet to return, many have experienced resurgence by incorporating more efficient supply chains and superior product selection. Despite the sector's growth since 1995, the market is far from saturated. Roberto Ramos, president of the MFA, pointed out to Econoff that there are

presently 55,000 franchise points of sale in Mexico - compared to 300,000 in Spain, a country with less than 40 percent of the Mexican population.

GROWTH DRIVERS

¶4. (SBU) Mexican franchise investors have traditionally been wealthy individuals with little interest in personally operating their branches, but this paradigm is changing. Increasingly, middle-class entrepreneurs are purchasing and managing franchises - according to data from the Mexican Franchise Association, 63 percent of new franchisees are making their first substantial investment. Ferenz Feher, a leading franchise consultant, pointed out to Econoff that layoffs of Mexican professionals coupled with an earlier retirement age has created a large group of potential middle-class investors. Ricardo Martinez explained to Econoff that he was an engineer who took an early retirement opportunity in order to purchase a Taco Inn franchise. Five years later, he now owns three restaurants, two bars, and has hired 38 employees. According to the MFA, 60 percent of non-franchise businesses fail within two years, while 95 percent of franchises are still in business after their fifth year. Given the relatively low cost of buying a franchise (from 5,000-100,000 dollars) and the greater security of a franchise investment, the franchise sector is empowering middle-class entrepreneurship on a large scale.

¶5. (SBU) Consumer credit is at an all-time high. Bancomer, one of Mexico's leading banks, announced recently that the total amount of credit offered increased by 70 percent during the first trimester of 2006, with the number of credit cards growing by 124 percent. As Mexicans are shopping and buying more, the resulting commercial real estate boom also fuels

franchising growth. Jorge Laventman, a real estate developer with GE Financial Services, explained to Econoff that shopping mall construction has risen by approximately 30 percent over the last three years, with no sign of slowing. New commercial shopping centers are primarily filled with franchises, driving demand. Jorge Yitani, master franchisor for Subway in the states of Puebla and Tlaxcala, is called weekly by a new shopping center requesting the placement of a new Subway branch.

¶6. (SBU) Franchising demand also drives itself. Carolyn Bass, an intellectual property lawyer for Gallastegui Armella, the leading franchise law firm in Mexico, explained to Econoff that the majority of her clients are owners of family restaurants and stores. As franchising expands throughout Mexico, especially in less populated communities, many local proprietors are threatened by newer, higher-profile chains. The legal protection in the Industrial Property Law offers small business owners an opportunity to protect their name, logo - even their recipes - by registering as a franchise. According to data provided by MFA, of the 180 new franchises created in 2005, 22 percent were small family owned Mexican businesses.

¶7. (SBU) Foreign franchisors have been more successful creating greater name recognition and developing a loyal customer base. Learning from past experience, many US-based companies are better able to "tropicalize", or adapt their products for the Mexican market. Yitani explained to Econoff the transformation made by Subway in the aftermath of their failed attempt to establish a viable franchise in Mexico in
¶1995. Today Subway conducts extensive market research regarding Mexican preferences, and varies its menu accordingly. Increasingly, chains use consultants to assist with cultural transition; in Mexico City there are now five major consulting firms.

FINANCING, ANYONE?

¶8. (SBU) While American investors are able to acquire financing from the Export-Import Bank or the Overseas Private Investment Corporation (OPIC), a deterrent to middle-class franchise investment in Mexico has been a lack of financing from Mexican banks. Beginning May 9, 2006, HSBC will offer small-business loans to prospective franchisees, and the Secretariat of the Economy plans to guarantee 40 million

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pesos (USD 3.6 million) of those loans. Luis Gonzalez, Director of Small Business Development for HSBC, explained to Econoff that the loan would cover up to 50 percent of the start-up costs of a franchise, with the interest rate and collateral determined on a case-by-case basis. Despite the fanfare, however, Ramos and other members of MFA expressed doubts regarding the effectiveness of this program, given its expected interest rate of 20-22 percent.

¶9. (SBU) A new initiative by the Mexican Franchise Association in conjunction with EW Financial Services may offer greater potential for potential franchisees. Ramos told Econoff that negotiations are taking place to enable various banks in the U.S., including Citibank and USBank, to offer small business loans through EW at an estimated interest rate of 7-8 percent. Ramos stressed that while this agreement has not yet been finalized; achieving greater access to financing is MFA's top priority. Isaak Sutton, co-owner of El Mundo de a 3 Pesos, the fastest growing franchise in Mexico, explained to Econoff that while the number of franchisee applications for his company rose by 50 percent in 2005, 70 percent of the applicants did not have the funds required for the initial investment. Increased financing options in the future may enable thousands of additional franchisees in Mexico, and spur the creation of thousands of jobs.

JUST ENOUGH OF A GOOD THING

¶10. (SBU) In January, 2006, as a result of extensive industry lobbying, Article 142 of the Industrial Property Law was amended, providing a new definition of franchises, mandating additional requirements for franchise agreements, and providing new standards for pre-sale disclosures. Most industry observers, including representatives from the MFA, consultants, and franchisors agreed that the new changes were a positive step forward. However, Ramos and other

franchisors expressed concern that more regulation was looming, which could impede growth in one of Mexico's most innovative economic sectors.

COMMENT

¶11. (SBU) With increased small business financing, a more secure legal environment, greater middle-class disposable income and confidence, and numerous underdeveloped areas outside of Mexico City, all signs point to strong continued growth of franchising in Mexico in the near future. There are potential threats to the franchise sector - overdevelopment of the commercial real estate sector, with a corresponding risk to imbedded franchises, and over-regulation of a competitive and thriving marketplace. However, there is a growing awareness among policy makers in Mexico City that by stimulating middle-class investment and job creation, the franchise sector will be a foundation of future economic growth.

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